The independent Office for Budgetary Responsibility (OBR) has effectively left its GDP growth forecast unchanged (table 1). A slightly lower-than-expected 2011 outturn has led to a slight upward revision for 2012 caused by the positive base effect. Within the details, the OBR has revised up its household consumption growth forecast as it sees some support from stabilising private employment and income growth outstripping inflation, largely as a result of the expected downward trend in inflation continuing. Repayments linked to payment protection insurance complaints are also expected to provide a small boost, but this crucial part of the economy is still expected to remain on life support.

With regards to business investment, despite the cut in corporation tax, the OBR has slashed its forecast of business investment growth by 90% for 2012 and by 30% over the whole forecast horizon. The OBR believes that non-financial private corporations are dealing with weaker balance sheets than official statistics are showing, but at the same time, the OBR is still forecasting business investment to be one of the key drivers of growth over the medium term.

Meanwhile, the government sector is still expected to make a meaningful negative contribution, but less than previously forecast and in line with the change in the profile of fiscal austerity; the trough in the growth of government consumption is now in 2015. Finally, the forecast for the contribution from net trade has been revised up marginally despite a major downward revision to the euro area GDP forecast - the UK’s biggest export destination.

For 2012 and 2013, the OBR’s forecast overall for growth is more optimistic than our forecast, and the consensus as measured by the Consensus Economics survey. Although our forecast begins to show an improvement in growth in 2014 and beyond, we believe (along with the consensus) that the economy is more likely to grow at between 2-2.5% rather than 3%.
Inflation and interest rates

The household sector was severely hampered by high inflation last year, which as mentioned above, is expected to ease. Now that the increase in VAT from 17.5% to 20% is falling out of the base of the annual calculation, inflation is expected to fall sharply over 2012. Given our more pessimistic outlook on growth, we expect inflation to fall further than the OBR’s forecast. However, we believe that there has been a structural upward shift in the price of imported goods, which means that the equilibrium inflation rate is no longer at 2%.

This is where the otherwise excellent analysis of the OBR warrants some stronger criticism. The OBR assumes that inflation will fall back to the government’s 2% target, yet it also assumes the Bank of England will follow an interest rate policy consistent with market pricing today. Looking at 3-month LIBOR futures, money markets are pricing in the first rise in interest rates in the middle of 2015, with only 100 basis points of rises by the start of 2017. In our view, taking together this interest rate profile and the OBR’s more bullish growth forecast, we believe the risk of inflation is firmly higher than 2%.

<table>
<thead>
<tr>
<th>Table 2: Inflation</th>
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<td><strong>CPI Q4, y/y (%)</strong></td>
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<tr>
<td>Budget 2012</td>
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<tr>
<td>Autumn Statement 2011</td>
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<tr>
<td>Budget Mar 2011</td>
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<td>PBR Nov 2010</td>
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<td>Schroders*</td>
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**RPI Q4, y/y (%)**

| Budget 2012        |      | 2.7  | 2.2  | 3.0  | 3.8  | 4.1  |
| Autumn Statement 2011 |   | 2.8  | 3.6  | 3.2  | 3.7  | 3.9  |
| Budget Mar 2011    | 5.1  | 3.4  | 3.6  | 3.6  | 3.9  | 3.9  |
| PBR Nov 2010       |      | 3.1  | 3.1  | 3.4  | 3.6  | 3.6  |
| Schroders*         |      | 1.9  | 2.5  | 3.8  | 3.9  | 4.1  |

*Consensus numbers are full year average. Source: OBR, Consensus Economics (March 2012), Schroders.

Our forecast sees interest rates rising by 100 basis points per year from 2014, but it also includes the Bank of England increasing the size of its Asset Purchase Scheme (or Quantitative Easing) by announcing another £50 billion in April, another £50 billion in August, and another £25 billion in November. This is consistent with our more negative outlook on growth and inflation. Indeed, the risk to our interest rate forecast is that the first rise is delayed further as currently priced in by money markets.
Public finances

Hopes of a significant windfall ahead of the Budget were dashed when awful public finance statistics were published the morning of the Budget. Public sector net borrowing (PSNB) was £7.3 billion more than consensus estimates for February, wiping out any unexpected surplus. So with his hands tied, the chancellor delivered a fiscally neutral Budget relative to GDP.

Table 3 (on next page) shows the latest OBR forecast compared to past forecasts, and our own. There is a significant fall in the deficit in 2012/13 thanks to the government’s decision to transfer Royal Mail’s pension fund back to the public sector. The decision that was announced in November is designed to shift the large deficit from Royal Mail’s balance sheet in order to help facilitate a possible privatisation deal in the future. The benefit for the government is that the future liabilities of the pension scheme are not accounted for in the public finances, only the assets. This will lower the deficit and level of debt by £28 billion, or 1.8% of GDP (see chart 3). Of course this is purely an accounting gimmick as the tax payer is now on the hook for the future unfunded liabilities of the Royal Mail pension scheme.

Chart 3: Headline public sector net borrowing

Once the Royal Mail distortion is worked through, the OBR forecasts the deficit to rise once again in 2013/14, before falling steadily throughout the forecast horizon. As a share of GDP, the deficit falls below the forecast nominal rate of growth by 2015/16, which means that total debt as a share of GDP peaks and begins to fall.

When compared to our own forecast, as we are more pessimistic on both real and nominal growth in the short-term, we expect the government to miss its targets over the coming years. Overall, we expect debt as a share of GDP to peak at 78.2% in 2015/16, before falling the following financial year. Cumulatively, we see debt being 0.6% of GDP higher than the OBR’s forecast (see table 3).
Talking Point UK Budget 2012: A little give and take

For professional investors and advisers only

The above net debt numbers exclude the costs associated with the financial sector interventions which are currently worth 74.8% of GDP. If included, this would put the UK’s debt number up there with the likes of Greece before the Hellenic Republic defaulted. What is interesting is that the cost of the bank bailouts has recently fallen thanks to some assets being sold, but also a pick-up in the share prices of part nationalised banks. These costs are down from 90.8% of GDP a year ago.

Looking at the decomposition of the deficit, the vast majority of it is still judged to be structural rather than cyclical (see chart 4). The size of the structural deficit is significant as this is the part of the deficit that will still be there even once the economy has recovered. This means that the only way to close the structural deficit (or cyclically-adjusted deficit as referred to by the OBR) is to increase taxes or cut spending - hence tough austerity measures.

Excluding the Royal Mail distortion, the government aims to reduce the deficit by £6 billion in 2012/13, though this is made up of £34.3 billion of cuts to the cyclically-adjusted budget deficit and an increase of 27.8% in the cyclical component of the deficit. The increase in the cyclical component of the deficit is caused by the weak economic outlook for the next financial year. This is the proportion of the deficit which we expect will overshoot in the near term.
The change in the cyclically adjusted deficit is thought to represent the fiscal impulse, or the true marginal impact of fiscal policy. The fiscal impulse was revised down for the past financial year at the Autumn Statement in November, however most of this was due to methodological changes in how the cyclically-adjusted deficit is calculated (see chart 5). All of this highlights the uncertainty in how these numbers are calculated, but what it also highlights is how the pain from austerity will continue for longer.

**Fiscal policy**

In terms of measures announced, with the exception of the ‘grannie tax’, none were a surprise thanks to the Treasury’s press office. The explosive press headlines that followed in the wake of the cut in the additional rate of income tax, and the freezing of the pensioners’ special personal allowance left Osborne looking like he had robbed ‘grannies’ to subsidise the rich.

Although the measures announced are fiscally neutral, the impact on the economic outlook is slightly positive. The measures focused on helping businesses could boost capital expenditure and growth over the coming years. For example, the continuing reduction in the corporation tax will help make the UK one of the most competitive in the advanced world when it comes to taxation. In addition, the long awaited announcement of the National Loan Guarantee Scheme (NLGS) - also known as the Credit Easing initiative - is an example of just one of the numerous measures designed to help small and medium-sized businesses.

The NLGS works by providing a number of banks £20 billion of guarantees to issue unsecured debt. This will lower the funding cost for those banks, and allow them to pass on the entire saving on to small and medium-sized firms in the form of cheaper loans, with a target discount of 1%. If the discount proves attractive enough, then more small and medium-sized enterprises may use these loans to invest and employ more people, boosting growth. The only downside to the scheme is that we believe it is currently too small to have a significant impact. However, this is now a new tool that this and future governments will have at their disposal that could be increased in the future.

In reaction to the measures announced in the Budget, we have raised our GDP forecast by 0.1% for 2012, 0.2% for 2013 and 0.1% for 2014. These are relatively small increases, though this is the first time in a long time we have been able to revise up our forecast on the back of changes in the Budget.

In terms of personal taxes, the lowering of the additional rate of income tax from 50% to 45% from 2013/14 was partly to appease Osborne's supporters, but was also done on the grounds that the measure had failed to raise barely a third of the amount that had been expected by the previous government under which it was introduced. In its place, the chancellor claims that he intends to raise five times more revenues from top earners than the 50p rate was collecting through the new 7% stamp duty levy on £2 million+ ‘mansions’ (otherwise known as residential properties in London).

The opposition have predictably pounced on the cut accusing the chancellor of passing on tax cuts to the most well off while there were more pressing and deserving people who should be helped. The main problem (as perceived by the left wing of society) with the switch away from taxing the rich through income tax is that there will be an instant benefit for earning more than £150,000 per year, for where the additional rate kicks in. Only those that will be buying property will really be bearing the brunt.

The chancellor also moved to aggressively tackle tax avoidance, again hitting housing by introducing a penal 15% level of stamp duty on residential property bought by overseas holdings, and also introduced the payment of capital gains tax as well.

However, we get the sense that the real targets of the government are rich foreigners who seek to own property in the UK in order to safeguard their assets. London has seen huge rise in demand for high quality properties from foreigners over the past two years, especially following the Arab Spring and the Greek and wider sovereign debt crisis in Europe.

The government's Liberal Democrat party contingent will be pleased in the acceleration of the raising in the personal tax allowance, which is expected to move 2 million people out of paying income tax at all. This is part of a wider strategy to increase the returns from work relative to remaining unemployed and dependent on the benefits. Reforms to the welfare state began last year with the means testing of disability benefits and the limits families can claim in housing benefits. The reduction in entitlements in Child Benefit payments was another stage in the process, which is likely to be a theme of this chancellor for the remainder of this parliament, and possibly the next.
As for the ‘granny tax’, while we sympathise with any group that finds itself paying more in tax, the older members of the population have largely escaped the austerity measures over the past two years. The chancellor announced the freezing and the eventual phasing out of the special age-related personal allowance, but did so by dressing it up as a tax simplification measure. The move will raise the exchequer just under £3.3 billion between 2013-14 and 2016-17. Osborne argues that no pensioner will lose out in nominal terms as increases in the state pension have offset the effect. The Institute for Fiscal Studies estimates that the policy change will only cut average incomes of those affected by 0.25% - hardly worth mentioning.

Box 1: Additional fiscal measures

**Personal taxes:**
- The threshold for the higher rate of income tax (40%) will be reduced from £42,475 to £41,450 in 2013/14, drawing in 300,000 more people.
- Automatic state pension age to ensure retirement age rises with life expectancy.
- New single tier state pension to be set at £140 for future pensioners.
- Child benefit will be cut for anyone earning over £60,000 per year, and tapered for between £50,000-60,000.
- Levy on non-domicile residents increased up to £50,000.
- Duty on Tobacco raised by RPI plus 5%.
- No change in alcohol duty, so it will automatically rise by RPI plus 2%. However, a consultation will take place on setting a minimum charge for the price of a unit of alcohol.
- New cap on tax reliefs set at 25% of total income for anyone claiming more than £50,000 in a year, but no significant change to pensions relief.

**Business:**
- Tax relief for the animation, high-end television production and video games sectors.
- Reforms to the reporting for small businesses designed to reduce admin burden.
- Relaxation of Sunday trading laws during the Olympics.
- Enterprise finance guarantee along with the ‘enterprise zones’ to be enhanced and expanded.
- The bank levy will be increased to 0.105% from January 2013 in order to offset the gains from the reduction in corporation tax.
- Tax relief for oil and gas extraction, after the disastrous past North Sea oil levy.

Overall, upon closer inspection of the details of the Budget, we find that the pro-business measures provide more room for optimism for the economic outlook. The UK economy still faces severe headwinds both domestically, and those caused by problems in Europe. The chancellor has managed to appease both sides of the coalition government, and has probably safeguarded the UK’s ‘AAA’ sovereign debt rating, and as long as he can avoid the angry ‘grannies’, he can relax until the fiscal circus returns again in the Autumn.

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